

Office of Chief Counsel
Internal Revenue Service

memorandum

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to: [REDACTED]
Petroleum Engineer, Examination Group [REDACTED]

from: [REDACTED]
Attorney (SB/SE)

subject: [REDACTED] TL-N-1776-99
[REDACTED] Cycle

Sale of Overriding Royalty Interests to [REDACTED] and [REDACTED]

This is to advise you of our conclusions regarding the transfer of certain overriding royalty interests from persons within the [REDACTED], consolidated group to persons both within and outside of the consolidated group. We have determined that this advice should be handled as a memorandum of Nondocketed Significant Advice pursuant to CCDM § 35.3.19.4. Under these provisions, the National Office will review our advice and notify us whether it concurs, believes modification is appropriate, or needs additional information.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Whether several inter-company transfers of overriding royalty interests conveyed economic interests to the recipients, and if so, how the transfers should be treated.

FACTS

A. Corporate Structure. [REDACTED] ("[REDACTED]"), a holding company owned [REDACTED] percent by [REDACTED] ([REDACTED]) and [REDACTED] percent by [REDACTED] ([REDACTED]), is the taxpayer here. It files a consolidated Form 1120 for most of the corporations referred to in this memo.

At the times relevant to this issue (between [REDACTED] and [REDACTED]), [REDACTED] owned [REDACTED] percent of [REDACTED] ("[REDACTED]"). Continuing down the corporate chain, [REDACTED] owned [REDACTED] percent of [REDACTED] ("[REDACTED]"), which owned [REDACTED] percent of [REDACTED] ("[REDACTED]"), which owned [REDACTED] percent of [REDACTED] ("[REDACTED]"). (this entity was originally named "[REDACTED]"), which owned [REDACTED] percent of [REDACTED] ("[REDACTED]"), which owned [REDACTED] percent of [REDACTED] ("[REDACTED]"). In addition, [REDACTED] owned [REDACTED] percent of [REDACTED] ("[REDACTED]").

B. [REDACTED] Transfer to [REDACTED]. [REDACTED] owned highly productive oil and gas properties in [REDACTED]. Because [REDACTED] could only claim cost depletion and not percentage depletion (see I.R.C. §§ 612, 613A(d)), its adjusted basis in these properties was low relative to their fair-market value. In three transactions, on [REDACTED], [REDACTED], and [REDACTED], [REDACTED] conveyed overriding royalty interests worth a total of \$[REDACTED] to [REDACTED], its parent. [REDACTED] asserts that these distributions did not constitute a dividend distribution, and the examination team is not currently challenging that assertion.

C. [REDACTED] Transfer to [REDACTED]. [REDACTED] owned properties similar to [REDACTED]'s. On [REDACTED], [REDACTED] conveyed overriding royalty interests worth \$[REDACTED] to [REDACTED]. [REDACTED] asserts that this distribution did not constitute a dividend distribution, and the examination team is not currently challenging that assertion.

D. Transfer of [REDACTED] General Partnership Interest. [REDACTED] and [REDACTED] created a limited partnership, [REDACTED] ("[REDACTED]") on [REDACTED]. At the time of [REDACTED]'s creation, [REDACTED] held a [REDACTED] percent general partnership interest and [REDACTED] held both a [REDACTED] percent general partnership interest and a [REDACTED] limited partnership interest. ([REDACTED] sold its limited partnership interest to [REDACTED] (a [REDACTED] corporation) in [REDACTED].) The partnership held producing and non-producing properties, stock in three corporations, and overriding royalty interests. The non-producing properties had a fair-market value of \$[REDACTED] and a basis of more than \$[REDACTED].

On [REDACTED], [REDACTED] conveyed a [REDACTED] percent [REDACTED] general partnership interest to [REDACTED]. [REDACTED] asserts that this is a dividend distribution, and the examination team is not currently challenging that assertion. At the time of this transaction, the partnership held only overriding royalty interests and stock in three corporations; its properties had been distributed to its related corporations.

E. [REDACTED] Formation and Operation. [REDACTED] revived a dormant subsidiary and renamed it [REDACTED] (" [REDACTED] ") in [REDACTED]. An outside investor, [REDACTED], purchased a [REDACTED] interest in this entity; a few days later, [REDACTED] increased its investment to the point that it became [REDACTED]'s [REDACTED] percent owner. [REDACTED] was outside the consolidated group in [REDACTED] and [REDACTED].

[REDACTED] sold a portion of its overriding royalty interests to [REDACTED] on [REDACTED], for \$ [REDACTED] in cash.

[REDACTED] had no employees or operations of its own. It acted as a clearinghouse for the income stream from its royalty interests: it collected the proceeds, paid dividends to its shareholders, and loaned the net proceeds to [REDACTED] under a revolving credit agreement. [REDACTED] and its subsidiaries bought all the oil and gas produced under its royalty interests. [REDACTED] guaranteed [REDACTED]'s dividend obligations with an irrevocable line of credit.

QUESTIONS PRESENTED

1. Did [REDACTED] hold an economic interest in any properties or interests it received from [REDACTED] or [REDACTED]?
2. If so, what was its depletable basis in those properties or interests?
3. Did [REDACTED] hold an economic interest in any properties it received from [REDACTED]?
4. When and what kind of gain would [REDACTED] need to recognize on these transactions?

CONCLUSIONS

1. [REDACTED] held an economic interest in all the overriding royalty interests it received from its subsidiaries. The [REDACTED] percent general partnership interest in [REDACTED] included depletable economic interests in the partnership properties. [REDACTED] does not need to have made direct or substantial investment in order to have an economic interest.
2. [REDACTED]'s depletable basis in each overriding royalty interest is its fair market value. Its depletable basis in the partnership properties is its proportionate share of the partnership's adjusted basis in its depletable properties.

3. [REDACTED] held an economic interest in each overriding royalty interest it received from [REDACTED]. It could only look to the production of minerals to return any of its capital investment in those interests.

4. [REDACTED] would need to recognize an ordinary gain on the transfer of any overriding royalty interests outside the consolidated group (for instance, to [REDACTED]). If an interest did not leave the consolidated group (for instance, the [REDACTED] percent general partnership interest in [REDACTED] and, by extension, the partnership's properties), [REDACTED] should treat the transaction as a deferred intercompany transfer.

ANALYSIS

1. Does [REDACTED] hold an economic interest?

Only a party who owns an "economic interest" in a mineral may claim a depletion deduction. Treas. Reg. § 1.611-1(b)(1). An economic interest is an interest which does not necessarily rise to the level of title in the property. Palmer v. Bender, 287 U.S. 551 (1933). To have an economic interest, the taxpayer must have acquired "any interest in the mineral in place" by investment, and must have secured income derived from the extraction of that mineral, "to which he must look for a return of his capital." Treas. Reg. § 1.611-1(b)(1).

[REDACTED] holds an interest in the minerals in place: an overriding royalty interest gives the holder a specific portion of production of a specific mineral deposit. The examiners questioned whether [REDACTED] holds an interest in which [REDACTED] made no direct investment, and thus does not meet the investment requirement of the "economic interest" test. Case law indicates that direct investment is not required.

The amount or nature of the investment does not affect whether an entity may claim a depletion deduction or has an economic interest. In a very similar case, the U.S. Tax Court found that corporate shareholders owned economic interests after the corporation assigned participating royalty interests to them in a non-dividend distribution. Beach Petroleum Corp. v. Commissioner, 5 T.C. Memo. 638 (1946). In Beach Petroleum, the shareholders did not have any capital investment in the stock, but did receive gain on their receipt of the interests. The gain qualified as investment: ". . . the cost of the investment to the beneficiary of the depletion right is unimportant. These stockholders received a part of the rights of the corporation which was the operator under the lease, and which, but for the assignment, would be entitled to depletion deductions . . ."

Courts have denied economic interests in cases where the interest owners have had some method other than mineral production to recoup their investment. In Anderson v. Helvering, 310 U.S. 404 (1939), the owner-operators of oil properties had paid \$160,000 for their properties. They paid the seller \$50,000 in cash at the time of sale, and \$110,000 from one-half of all oil and gas produced from the properties and from the sale of any of the properties. The owner-operators attempted to claim that the seller retained an economic interest in the properties, and thus they were not taxable on the \$110,000 from mineral production. The Supreme Court found that the seller's reservation of a fee interest in the properties meant that it was not entirely dependent upon oil production for payment, and thus did not have an economic interest in the mineral. 310 U.S. at 412. Anderson presents the reverse of the standard litigation posture: the taxpayers there wanted to disavow an economic interest, because they did not want to report the \$110,000 as income. Though the court did not explicitly determine that the Anderson taxpayers were entitled to the depletion deduction, it did state that the issue of who owned an economic interest and which party was entitled to the deduction was the same issue. 310 U.S. at 407.

Here, [REDACTED] has a capital investment in the distributing companies. Gains would be recognized on the transfers of the overriding royalty interests to [REDACTED]. Although the gains are deferred, see below, that deferral does not change the character of the actual interests held by [REDACTED] from "economic interest" to "economic advantage." [REDACTED] has an economic interest in the overriding royalty interests it received from [REDACTED] and [REDACTED].

[REDACTED] holds an economic interest in the overriding royalty interests contributed to it by [REDACTED] it exchanged a [REDACTED] percent general partnership interest for the royalty interests. Because of the pass-through nature of a partnership, a partnership share includes a distributive share of the depletion deduction. I.R.C. § 702(a)(7).

Although [REDACTED] would have made no direct investment in the overriding royalty interests or their underlying mineral properties, the same analysis would apply to the partnership distribution as would apply to the distributions from [REDACTED] and [REDACTED]. [REDACTED]'s dividend distribution of a [REDACTED] percent general partnership interest to [REDACTED] would grant [REDACTED] an economic interest in the oil and gas properties underlying the royalty interests to the extent of its proportional partnership interest in the properties.

2. [REDACTED]'s basis in properties

I.R.C. § 1012 defines a property's basis as its cost to the holder, unless otherwise specified. Section 301(d) specifies otherwise: [REDACTED]'s basis in the overriding royalty interests it holds directly would be the fair market value of those interests.

[REDACTED] and [REDACTED] distributed the interests to [REDACTED] "in respect of its stock" (that is, in its capacity as a stockholder rather than as a purchaser or other role). This distribution from a corporation to its shareholder is to be "treated in the manner provided in subsection [301](c)." I.R.C. § 301(a). Subsection 301(c) requires non-dividend distributions to reduce the shareholder's adjusted basis in the stock. The amount of the distribution is defined as money plus the fair market value of any property received. I.R.C. § 301(b)(1). If the distribution is greater than the adjusted basis, the shareholder must treat that amount in excess of basis as a gain from the sale or exchange of property. I.R.C. § 301(c)(3)(A).

[REDACTED] and [REDACTED] would need to treat the distributions as sales. Section 311(b)(1) requires a distributing corporation to recognize gain on the distribution of appreciated property "as if such property were sold to the distributee at its fair market value."

Having established its basis in the overriding royalty interests, [REDACTED] must then continue to track the adjustments to basis by reason of depletion deductions. Because [REDACTED] both produces and sells oil products at the retail level, it cannot take percentage depletion. I.R.C. § 613A(d)(2). Section 612 provides that the basis for purposes of cost depletion is the adjusted basis from I.R.C. § 1011. Depletion deductions continue to decrease the adjusted basis. I.R.C. § 1016(a)(2). As a result, [REDACTED]'s depletable basis and its adjusted basis are identical.

[REDACTED]'s [REDACTED] percent general partnership interest in [REDACTED] presents a similar analysis. Under I.R.C. §§ 705(a) and 742, [REDACTED] would look to the standard basis rules of I.R.C. §§ 1011-1023 to calculate its basis in the partnership interest; rules in those sections refer to the corporate distribution basis rules of I.R.C. §§ 301-311. Without further adjustment, [REDACTED]'s basis in its [REDACTED] partnership interest would be the interest's fair market value; however, the code provides for one more adjustment to the basis.

[REDACTED] made an election under I.R.C. § 754 to adjust the basis in its property upon the transfer of an interest by sale or

exchange. This election allows [REDACTED] to adjust its basis in its partnership interest by the difference between the interest's fair market value and [REDACTED]'s proportionate share of the adjusted basis of the partnership's properties. I.R.C. § 743(b). Thus, [REDACTED]'s basis in its [REDACTED] partnership interest would be its proportionate share of the partnership properties' adjusted basis.

3. Does [REDACTED] have an economic interest?

The examination team questioned whether the arrangement by which [REDACTED] guaranteed [REDACTED]'s dividend obligations meant that [REDACTED] could look elsewhere for a return of its capital investment in mineral rights. If so, [REDACTED] would not have an economic interest.

We have found no case in which the holder of an overriding royalty interest is found to have no more than an "economic advantage" in the minerals, and conclude that [REDACTED] holds a depletable economic interest as a result of its purchase of mineral rights from [REDACTED].

[REDACTED] paid [REDACTED] \$[REDACTED] for its overriding royalty interests. The only way that [REDACTED] receives any return on this purchase price is through oil and gas production. Production from the underlying oil and gas properties is sold to [REDACTED] and its subsidiaries. What [REDACTED] decides to do with the proceeds of that mineral production, and what other obligations [REDACTED] and its parent corporations have chosen to undertake, are irrelevant to [REDACTED]'s economic interest in the overriding royalty interests.

If [REDACTED]'s interest did not qualify as an economic interest, it would be labeled an "economic advantage." Treas. Reg. § 1.611-1(b)(1). An example of an "economic advantage" is a contract between a miner and the owner of mineral rights paying the miner to extract minerals. *Id.* Another example is a contract allowing a purchaser to buy minerals after production. *Scofield v. LaGloria*, 268 F.2d 699 (5th Cir. 1959). Holders of economic advantages generally have no interest in a specific mineral deposit, or they have some other way to make money from their contractual right than production of the specific mineral deposit.

4. Deferred Gain and Section 1254 Recapture

[REDACTED]'s receipts of overriding royalty interests and partnership interests qualify as deferred intercompany transactions. Treas. Reg. § 1.1502-13(a)(2)(i) (as in effect until July 12, 1995). As such, any gain or loss on these

transactions is deferred until the properties are transferred outside the consolidated group. Treas. Reg. 1.1502-13(c)(1)(i).

The distributing corporations ([REDACTED] and [REDACTED]) recognize a portion of the deferred gain in each year, based on [REDACTED]'s depletion deduction. Treas. Reg. § 1.1502-13(d)(1). This partial recognition of gain reduces the deferred gain accordingly. Treas. Reg. § 1.1502-13(d)(3). The deferred gain is treated as ordinary income. Treas. Reg. § 1.1502-13(c)(4)(ii); Georgia Pacific Corp. v. U.S., 648F.2d 653 (9th Cir. 1981).

Because the basis in the overriding royalty interests is adjusted for depletion deductions, these properties qualify as "Section 1254 property," and any gain on their sale is treated as ordinary income. I.R.C. § 1254(a)(1), (a)(3)(B).

BERNARD B. NELSON
Area Counsel (LM:NR)

By: [REDACTED]

Attorney (SB/SE)

cc: [REDACTED]

Special Litigation Assistant (LM:NR)